COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

THE BERKSHIRE GAS COMPANY	)	D.T.E. 03-89

INITIAL BRIEF OF THE BERKSHIRE GAS COMPANY

I. INTRODUCTION

On September 15, 2003, The Berkshire Gas Company ("Berkshire" or the "Company") filed the Petition of The Berkshire Gas Company for Approval of a Financing Plan Involving the Issuance from Time To Time of Long-Term Debt Securities in an Amount Not to Exceed $20,000,000 (the "Petition"). In the Petition, the Company requested that the Department authorize the issuance, from time to time for a period ending January 31, 2007, of up to $20,000,000 in long-term debt securities pursuant to G.L. c. 164 §14. The Company's Petition noted that the new debt securities issued pursuant to the proposed financing plan would be applied to the payment of certain outstanding long-term indebtedness, the payment of capital expenditures for properly capitalizable additions to property plant or equipment or for the payment obligations of the Company incurred for such expenditures, the refinancing of short-term debt, general working capital purposes and for such other purposes as the Department might authorize. Petition, p. 2. In the Petition, the Company also requested that the Department exempt it from the requirements of G.L. c. 164, §15A with respect to the issuance of long-term debt securities at par and the competitive bidding requirements of G.L. c. 164, §15. Finally, the Company requested that the Department approve the

Company's application for authority to engage in certain transactions to mitigate "floating rate" risk in connection with the issuance of long-term debt securities pursuant to the proposed financing plan.

The Department conducted a public and evidentiary hearing on the Petition on December 3, 2003. The Attorney General filed a notice of intervention in the proceeding pursuant to G.L. c. 12, §11E on December 3, 2003. The Company presented the testimony of Karen L. Zink, Vice President and General Manager of Berkshire, in support of the Petition. The Company's responses to information and record requests of the Department were also included in the evidentiary record in this proceeding.

Pursuant to a procedural schedule established by the Hearing Officer, the Attorney General submitted an initial brief in this proceeding on December 11, 2003. This Initial Brief of the Company is also filed consistent with the Hearing Officer's procedural schedule.

The Company submits that Ms. Zink's testimony and supporting analyses and schedules support in full the requests contained within the Petition. In his Initial Brief, the Attorney General has only challenged two limited aspects of the Company's Petition. First, the Attorney General has asserted that the Company has not fully satisfied the so-called "net plant" test which is derived from G.L. c. 164, §16. See Colonial Gas Company, D.P.U. 84-96 (1984). Second, the Attorney General has questioned the merits of approving the proposed interest rate mitigation transactions proposed by the Company. AG In. Br., pp. 1-2. As the Company's exhibits and testimony fully support all other aspects of the Petition, this Initial Brief of the Company will only respond to the issues raised by the Attorney General.

II. STANDARD OF REVIEW

Department precedent has long held that in order to approve the issuance of stock, bonds, coupon notes, or other types of long-term indebtedness by a gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations pursuant to G.L. c. 164, §14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985). The Company's stated purposes for the proposed financing plan, including the proposed use of hedging transactions, fully satisfy this requirement which bases have not been challenged by the Attorney General. Second, the Department must determine whether the Company has met the so-called "net plant" test. Colonial Gas Company, D.P.U. 84-96 (1984). Regarding the "net plant" test, the Department has held that a company is required to present evidence that its net utility plant (original cost of capitalizable plant less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding) and will continue to do so following the proposed issuance. Colonial Gas, D.P.U. 84-96, p. 5. The Company's evidentiary presentation has demonstrated that the Petition has satisfied these standards or, at a minimum, reasonable conditions may be put in place by the Department with respect to the net plant test.[1]

[1] While the net plant test is commonly applied for requests pursuant to G.L. c. 164, §14, it is inapplicable to Berkshire's request to engage in hedging transactions because the amount of debt long-term outstanding will not change pursuant to such derivative instruments, which shall have a maturity of less than one year. Tr. 20.

III. THE ATTORNEY GENERAL'S ARGUMENTS WITH RESPECT TO THE NET PLANT TEST ARE MISPLACED

The Attorney General asserted that Berkshire has only demonstrated that it had authority to issue approximately $7.75 million worth of additional debt based upon his calculation of the Company's net plant. AG In. Br., p. 3. The Attorney General noted that the Department has, however, approved some financings where the utility's balance sheet did not currently meet the net plant test and conditioned such approval on contemporaneous compliance filings showing that the additional financing meets the net plant test. This process ensures that any subsequent financing would comply with G.L. c. 164, §§14 and 16. Id. at p. 4.

As an initial matter, the Company notes that the Attorney General's argument does not reflect the correct calculation of the Company's currently available net plant. In fact, the Company's response to DTE-RR-1 (a revised version of Schedule KLZ-5) indicates that, as of September 30, 2003, the Company had $9,978,000 of excess net utility plant to total securities and debt.[2] Thus, at a minimum, the Department should find that this amount of additional long-term debt may be issued without any condition relating to compliance with the net plant test.

The Company also demonstrated that, during the term of the proposed financing plan, an existing $6 million Medium Term Note payable in April 2004 shall be retired. Further, limited sinking fund payments will also be made with respect to the Company's preferred stock. Exh. BG-1, p. 6; Exh. BG-6. The Company also explained that its current net utility plant has been artificially constrained due to the lack of routine construction activity associated with an on-going strike of its union employees. Exh.

[2] This included approximately $4,705,400 of a note paid off in September of 2003 that was also reflected in the Attorney General's calculation.

BG-1, p. 6; Exh. DTE 1-4. The Company has developed detailed plans and procedures for the resumption of a more normal level of construction activity upon the resolution of the strike and the return to work of the relevant employees. The Company demonstrated that as a result of these financial commitments and the application of its detailed construction resumption plan, the Company would have more than adequate net utility plant to support the full $20 million level of the proposed financing plan. DTE-RR-1.

The Company would, however, be amenable to the adoption of somewhat similar conditions to those imposed by the Department in Boston Edison Company, D.T.E. 00-62 (2000). In this proceeding the Company believes an appropriate structure would be first for the Department to authorize the issuance of up to $9,978,000 of additional long-term debt securities without any condition. In addition, the Company should be permitted to issue up to an additional $6 million of debt securities if either (i) such issuance takes place after the retirement of the $6 million Medium Term Note due and payable on April 1, 2004 or (ii) the proceeds from the financing of such amount is used to retire such note. Finally, the Company would also be willing to provide certification to the Department as to additional levels of net plant associated with preferred stock dividend payments and construction activities as its plan of construction resumption proceeds. This certification would demonstrate that additional net plant has become available or been added by the Company to support such financing. The Company believes that only very limited review by the Department would be necessary with respect to such certification and the review should be limited only to the determination of the Company's actual net plant level.

IV. THE COMPANY DEMONSTRATED THE BENEFITS OF ITS PLAN TO MITIGATE "FLOATING" RATE RISK

A. Hedging Transactions May Yield Substantial Benefits and are Permitted by Department Precedent

The Company's Petition included a request for authority to employ interest rate locks or other similar instruments (such as caps or collars) to manage interest rate volatility and "floating" rate exposure. As an example of this type of transaction, the Company noted that if it determines that market conditions are "attractive for a long-term financing and [the Company wishe[d]] to effectively 'lock in' then current rates prior to completing a transaction permissible under this financing plan, the Company could employ an interest rate lock to ensure that the benefit of such attractive rate is secured." Exh. BG-1, p. 18.

The Department has previously recognized that derivative transactions meet the standard of review pursuant to G.L. c. 164, §14 (reasonably necessary to accomplish a legitimate purpose associated with a utility company's service obligations), and has approved the use of such transactions. In New England Power Company, D.P.U. 91-267, New England Power Company ("NEP") requested authority to enter into $617 million of interest rate swaps. NEP set forth three types of derivative transactions in which it wished to engage. First, NEP requested approval to use derivatives "to take advantage of low interest rates prior to the call date of its existing bonds and to provide a hedge against a rise in interest rates for the period between the call date of its existing bonds and the issuance date of new bonds [citations omitted]." New England Power, D.P.U. 91-267, p. 8. Second, NEP requested approval to enter into "fixed-to-floating interest rate with a counterparty [footnote omitted]." Id. Third, NEP requested approval to "enter into a floating-to-fixed interest rate swap with a counterparty" [footnote

omitted]. Id. At least some of these are generally similar to types of derivative transactions in which Berkshire has sought authority to execute.

The Department ultimately determined that savings would result and that risks could be managed by employing NEP's proposed risk mitigation strategy and approved NEP's request. Id. at 15. Importantly, as noted below, Berkshire's proposal involves greater limits and only hedging and is therefore more protective of customers than the NEP approach. Accordingly, the Department should find that the Company's proposed use of only hedging transactions is reasonably necessary to accomplish a legitimate purpose associated with its service obligations.

Berkshire demonstrated that the use of these types of instruments is particularly beneficial in periods of substantial market volatility. Indeed, Ms. Zink's testimony and the response to record request DTE-RR-3 demonstrates that the financial markets remain extremely volatile. As recently as this past summer, a period of just over one month saw an increase of approximately 102 basis points in the yield rate for long-term US Treasuries. Tr. 21; Exh. DTE 2-1; Exh. BG-15, pp. 2-3 (6/24/03 - 4.31%; 7/31/03 - 5.43%). Ms. Zink's testimony further demonstrated how the proposed types of transactions may be applied to lock in the terms of current market conditions for the ultimate benefit of the Company and its customers. Exh. BG-1, p. 19; Tr. 17-21.

The Attorney General opposes the Company's request for authority to pursue these well-accepted hedging techniques. AG In. Br., pp. 4-8. The Attorney General's arguments are based on his mistaken belief that those types of transactions are not necessary, that the Company has somehow sought authority for the purposes of engaging in speculative or risky transactions and that the Company has not demonstrated appropriate expertise or established appropriate controls on such

transactions. As noted in Ms. Zink's testimony, the Company demonstrated that these hedging instruments remain an important tool to mitigate risk for the benefit of the Company and customers, that the Company will not engage in risky speculative transactions but, rather, only hedging, and that the Company maintains appropriate expertise and has established substantial internal controls and procedures.

B. Berkshire has Demonstrated that Hedging Authority Remains "Necessary" to Secure Savings

Contrary to the substantial record evidence presented by the Company, the Attorney General argued that the use of hedging techniques is not necessary because of the Company's proposed use of private placements with "planning and foresight." AG In. Br., pp. 7-8. The Attorney General is partially correct in noting that the use of private placements is an important means by which the Company may seek to manage floating rate risk and justifies the Company's request for a waiver from the requirements of G.L. c. 164, §15. The Attorney General, however, ignores the fact that substantial market volatility risk remains even when a private placement is pursued. Two "real world" examples demonstrate the nature and magnitude of this risk and the opportunities available through a well-structured hedging strategy such as that proposed by the Company. The use of "foresight and planning" in the context of a private placement does not, as suggested by the Attorney General, change the fact that it typically takes more than one month under the best of conditions to close a private placement, particularly if the Company seeks to implement some form of competitive process among potential lenders. Exh. BG-1, p. 17; Exh. DTE 1-17. In a period like

July 2003, this lag would have resulted in millions of dollars in additional interest expense over the life of a long-term note.[3]

A second very real opportunity is ignored by the Attorney General. As Ms. Zink's testimony demonstrates, the Company's 6.1% Medium Term Note matures in April, 2004. Exh. BG-4. If, for example, the Company now maintained the authority to pursue the hedging transactions proposed and the Company determined that interest rates were lower now than they likely will be in April 2004, the Company could "lock in" such low rate today even though, as a practical matter, the refinancing of the Medium Term Note could not take place until April 2004, a period of several months. To pursue this strategy, the Company might execute a "treasury lock"[4] with a maturity date in April 2004 coinciding with the refinancing of the Medium Term Note. As Ms. Zink explained, if interest rates on Treasury securities do trend upwards, Berkshire would receive a settlement payment in an amount comparable to the net present value of the change in rates from the execution date (i.e., today) to settlement date (i.e., April 2004). Tr. 19-20. The gain would be amortized over the life of the bond or note issued by Berkshire consistent with Financial Accounting Standards Board, SFAS 133. Exh. BG-1, p. 18; Tr. 20.

Thus, as a practical matter, and contrary to the assertions of the Attorney General, the use of the private placement of debt securities alone would not enable the

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[3] Assuming an additional one hundred basis points of interest on a $20 million, thirty year note, added interest payments would equal $6 million ($20 million x 1% x 30 years). Treasury rates actually increased by more than 100 basis points during a five week period in July 2003. Cf. Exh. BG-15.

[4] The Company is typically only able to "hedge" the rate of a Treasury security with a comparable maturity to the security proposed to be issued. The "spread" over such Treasury security reflecting Company-specific risk would likely remain the same over a short period absent a material change in the Company's financial condition. The Attorney General suggests that the use of hedging is not "reasonably necessary" as it increases the "risk profile" of the Company "while benefiting only shareholders." AG In. Br., p. 5. A pure hedging strategy (as opposed to speculation) is, to the contrary, likely only to reduce risk. While most company-specific risk may not be hedged, hedging may eliminate rate volatility exposure for the Company, an important concern in the capital-intensive utility industry.

Company to manage floating rate risk to the same degree. The proposed use of the standard hedging instruments is reasonably necessary to enable the Company to manage market volatility and to seek to reduce debt costs for the benefit of the Company and its customers. Accordingly, the Department should find that the authority to pursue hedging transactions is reasonably necessary to manage market risk and approve that component of the Company's proposed financing plan.

C. Berkshire has a Strong Incentive to Secure the Most Favorable Financing Terms

The Attorney General next goes on to suggest that the use of hedging techniques will somehow create an additional incentive for the Company to negotiate inferior terms for long-term debt issuances and then "gamble" seeking shareholder profit. AG In. Br., p. 5. The Attorney General provided two examples to support this reference. These examples, however, demonstrate his lack of understanding of the nature of "hedging." The Attorney General's examples are, in fact, speculative transactions and not hedging. Speculation of the sort suggested by the Attorney General is (i) not proposed by the Company (Exh. BG-1, pp. 18-19); (ii) is not permissible under the Company's firm "Derivatives Policy" (Exh. BG-11 "Berkshire will not enter into any speculative derivative transactions. The use of derivatives will be confined to risk management (hedging) activities only and will be used as part of defined strategies to manage risk . . . ."); and (iii) given requisite accounting practices and the fact that the Company is now operating under a long-term performance-based rate plan approved by the Department in D.T.E. 01-56, Berkshire's management has no incentive other than to apply its best efforts to secure low cost debt issuances pursuant to the proposed financing plan (Exh. BG-1, pp. 19-20).

As noted, the Company is only requesting authority to engage in hedging transactions (i.e., transactions that lock in a level of interest expense savings) and has proposed a wide range of controls that specifically preclude the type of speculative transactions that might create an opportunity for profit. Again, the Company's comprehensive Derivatives Policy clearly precludes speculation. Exh. BG-11. The policy also includes a specific provision regarding the limits in terms of leverage that, as a practical matter, limits the Company to hedging transactions. Id. The Company has also proposed a number of other controls, including disclosure of such activity consistent with the requirements of the Securities and Exchange Commission and the Financial Accounting Standards Board. Exh. BG-1, p. 19. All counterparties will be required to maintain a superior credit rating. Exh. BG-11; Exh. BG-1, p. 19. Only industry standard forms will be applied. Id. In sum, the Company's Derivative Policy and other proposed actions provide more than adequate controls for only hedging transactions and, therefore, eliminates the possibility of an inappropriate incentive.

Ms. Zink also explained that the performance-based rate plan approved in D.T.E. 01-56 has created a strong incentive for the Company to manage all costs. Exh. BG-1, p. 19. Ms. Zink also explained that its ability to pursue cost savings of all types and manage financial risk were critical in enabling the Company to agree to a lengthy rate freeze and price-cap rate structure. Id. at 20. In sum, the Company's incentives in securing a least cost financing plan are wholly consistent with the interests of customers.

D. Berkshire has Substantial Expertise and Controls for any Hedging Transactions

Finally, the Attorney General suggests that the Company has not established the "necessary expertise" or "appropriate internal controls" to implement

hedging transactions. AG In. Br., p. 6. In fact, the Company maintains substantial and appropriate expertise and, as noted, a range of established controls and procedures have been put in place. First, the Company and Energy East have substantial expertise and experience in closing a wide range of financial transactions. This expertise would be applied to the proposed financing plan. Exh. DTE 1-10; Exh. DTE 1-17. Further, the Company's Derivative Policy establishes express limitations on which executives of the Company may execute derivatives transactions for hedging purposes. That is, only senior executives within the Energy East system may pursue such transactions. Exh. BG-11.[5] A formal, written memorandum to the Company's financial executives is required with respect to the strategic objective being pursued, the overall "business purpose" and the planned "exit strategy." The Treasurer's organization must review this proposal and establish specific "credit limits" for each transaction prior to execution. Id. Accordingly, the substantial experience within Energy East and Berkshire with financial transactions will necessarily be applied in a rigorously controlled environment for any hedging strategy pursued by the Company. Exh. BG-1, p. 19; Exh. BG-11[6] Moreover, the Company has adopted substantial reporting requirements not only to the Treasurer's organization but to the Audit Committee of the Board of Directors. Exh. BG-11. In sum, the expertise to be applied to a hedging strategy is impressive and the internal controls are substantial and meaningful. Accordingly, the Department should dismiss the Attorney General's specious arguments as to expertise and control.

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[5] The Attorney General's flip suggestion that non-financial officers will be engaged in hedging transactions is unsupported and should be dismissed. Cf. AG In. Br., p. 7.

[6] Notably, the Department has authorized the Company to pursue similar hedging strategies with respect to gas supply. See The Berkshire Gas Company, D.T.E. 01-41, p. 14 (2001). The Department, consistent with the Company's proposal in this proceeding, barred "speculative financial arrangements," acknowledged the Company's Derivatives Policy and limited techniques to those "traditionally used by Massachusetts utilities." Id.

V. Conclusion

In sum, the Company's overall financing plan as described in the Petition is in the interest of customers and satisfies Department precedent. In particular, Berkshire has adequate net plant (and has proposed a reasonable action plan) in support of the satisfaction of the net plant test. Berkshire's proposal to manage floating rate exposure is beneficial to customers and supported by Department precedent. Engaging in appropriate hedging transactions is reasonably necessary to accomplish a legitimate gas company purpose associated with Berkshire's service obligations. Substantial and appropriate controls and procedures have been established. Accordingly, the Department should approve Berkshire's overall financing plan for the issuance of up to $20 million of long-term debt securities, including its request for authority to engage in certain specified hedging transactions.

Respectfully submitted,

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